Passthrough Partner


By J. Leigh Griffith

For federal income tax purposes, an S corporation is a form of pass-through entity and generally does not pay federal income tax on its income and gain. Income is passed through to the shareholders in accordance with stock ownership. Losses are similarly passed through to each of the S corporation’s shareholders to the extent of the shareholder’s adjusted basis in stock and debt of the S corporation to such shareholder. With respect to S corporation debt to shareholders that can support losses, the language of Code Sec. 1366 only requires that the debt be between the S corporation and the shareholder. Losses in excess of the adjusted basis of such debt and the adjusted basis of a shareholder’s stock are suspended. To the extent losses are passed through to a shareholder, subject to various limitations such as the “at risk” rules and passive activity loss limitations, they may be used to reduce the shareholder’s other taxable income and gain. S corporation losses flowing to a shareholder first reduces the shareholder’s adjusted basis in his or her S corporation stock and then the adjusted basis in any indebtedness of the S corporation directly to the shareholder. S corporation income first increases the adjusted basis of a shareholder’s S corporation debt and then the adjusted basis of such shareholder’s stock.

Unlike a partnership in which the entity level debt is shared by its partners and increases each such partner’s basis, S corporation debt to others does not increase the basis of the S stock in the hands of its shareholders. All too frequently, an S corporation shareholder is looking at S corporation losses that are suspended and cannot currently be used by such shareholder because the shareholder does not have sufficient adjusted basis in the shareholder’s S stock or S debt.

The situation of inadequate basis has generated a great deal of confusion and controversy for both the taxpayers and the courts. Code Sec. 1366 provides the aggregate amount of losses and deductions taken into account by a shareholder cannot exceed the adjusted basis of the shareholder’s stock and “the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder ...” It is particularly frustrating to shareholders who have guaranteed S corporation third party debt, have the economic risk of loss, but cannot utilize S corporation losses because of the lack of basis. The guarantee itself does not generate basis. In contrast, a partner obtains basis as a result of the partner’s share of partnership debt whether or not such debt is guaranteed.

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Shareholders have tried a variety of methods to attempt to increase their debt-adjusted basis in order to take advantage of current S corporation losses. Often S corporations are smaller businesses with less sophisticated tax advisors who become confused by the different tax rules applicable to partnerships and S corporations. In addition the courts also have gotten confused and have created and misapplied a judicial doctrine of “actual economic outlay” with respect to back-to-back loans whereby a shareholder (1) borrows funds from a related party and reloans the funds to the S corporation or (2) restructures a related-party debt to the S corporation into a related-party debt to the shareholder followed by a loan from the shareholder to the corporation. These methods include (1) guarantees; (2) loans from entities owned by the shareholders to the S corporation; (3) contribution of shareholder notes (including demand notes); (4) attempted restructuring of related-party debt to cause such debt to be an obligation of the S corporation to the shareholder with the shareholder owing the related party an amount equal to such debt; and (5) a circular flow of funds whereby (a) a second entity owned by a shareholder loans dollars to the shareholder, (b) the shareholder contemporaneously loans similar amounts to the S corporation, and (c) the S corporation repays loans or other obligations to the second entity in a similar amount.

Final Regulations

Reg. §1.1366-2 concerning Code Sec. 1366(d)(1)(B) was amended in July 2014 to address or clarify debt basis issues in three situations: (1) basis increases related to guarantees or similar arrangements involving a loan to an S corporation; (2) basis increases involving a loan directly to an S corporation from an entity related to the S corporation shareholder under the so called “incorporated pocketbook” theory; and (3) basis increases associated with traditional back-to-back loans. These final regulations (“Final Regs.”) do not address basis increases of stock and the Treasury is continuing to study those issues. The Final Regs. leave it up to existing law to define what constitutes a *bona fide* debtor-creditor relationship between the S corporation and a shareholder. While the determination is fact and circumstance specific, the circular flow of funds structures present difficult analytical issues and are likely to lead to many future disputes between the taxpayer and the IRS, subsequent litigation and inconsistent court results.

Shareholder Guarantees of Loans

The Final Regs. clearly provide that the guarantee of an S corporation debt, serving as a surety for an S corporation’s debt, serving as an accommodation party, or in any similar capacity relating to a loan does not create or increase the basis of indebtedness to a shareholder until there has been an actual economic outlay by the shareholder. For this purpose, a payment by an entity disregarded for federal income tax purposes in which a shareholder is the sole owner is considered a payment by the shareholder. The actual economic outlay standard as developed by the courts requires that the shareholder be made “poorer in a material sense” to increase his basis in S corporation indebtedness. In this context, courts have concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds form a related entity and then lent those funds to his S corporation. Rather baffling to the author is the preamble’s statement: “With respect to guarantees, however, the Final Regs. retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee.” The text of the Final Regs. retains the requirement that for the shareholder to have basis, the shareholder must perform under the guarantee. Performance or payment, however, may be different than complying with “economic outlay.” Presumably the shareholder’s payment on the guarantee creates a right of subrogation and therefore the basis will be with respect to debt from the S corporation to the shareholder. The author does not believe the statement in the preamble regarding the application of the economic outlay standard is technically accurate if the courts’ engrafting of “poorer in a material sense” is included in such a meaning. If the shareholder receives funds *via a bona fide* loan from a related entity (or wholly owned entity that is not disregarded) or a distribution from such entity and uses those funds to pay a guarantee, the shareholder should have basis. If the shareholder has subrogation rights, the basis should be that of debt under Code Sec. 1366(d)(1)(B). If the shareholder does not have subrogation rights, the shareholder should have basis under Code Sec. 1366(d)(1)(A).
Incorporated Pocketbook

In these transactions, the transfer from a related entity directly to the S corporation is found to be made on the shareholder’s behalf and is, in substance, a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation. It is fairly rare that this will be found to be the case. The Final Regs. did not eliminate this possibility, but a loan by an entity owned by the taxpayer does not constitute a loan of the shareholder unless the facts and circumstances establish a *bona fide* creditor-debtor relationship directly between the shareholder and the borrowing S corporation. On September 21, 2012, as reported by Tax Analysts, Caroline Hay, branch 3 attorney-advisor, IRS Office of Chief Counsel (Passthroughs and Special Industries) and the principal author of the Final Regs., commented on the then-proposed regulations and indicated that under the appropriate facts and circumstances the “incorporated pocketbook” situations could be classified as a *bona fide* debt to the shareholder and therefore provide basis under Code Sec. 1366(d)(1)(B).

Back-to-Back Loans

According to the preamble of the proposed regulations, the regulations were proposed to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness. The preamble to the Final Regs. states an S corporation shareholder need not otherwise satisfy the “actual economic outlay” doctrine for purposes of Code Sec. 1366(d)(1)(B). The preamble to the Final Regs. also states “... the proposed regulations provided that shareholders receive basis of indebtedness if it is a *bona fide* indebtedness of the S corporation to the shareholder.” The driver for the regulation was to reduce the frequency of disputes between S corporation shareholders and the IRS and reduce the uncertainty on the part of both the shareholder and the government. When the shareholder has related entities and loans between and among the shareholder and/or the related entities, economic substance and tax consequences get rather confusing. The Code (and the new Final Regs.) require the “indebtedness of the S corporation to the shareholder.” The courts had moved away from legal rights into the area of an “actual economic outlay” standard when analyzing back-to-back loans or other arrangements involving related entities, the shareholder, and a loan or purported loan from the shareholder to an S corporation. The courts often looked to see if the shareholder was “poorer in a material sense.” Consistent with the Code, the Final Regs. merely provide if there is a *bona fide* indebtedness between the S corporation and the shareholder, the shareholder will have basis. How to determine what constitutes a *bona fide* indebtedness is left to the federal tax common law—much of which has been developed outside of Code Sec. 1366. The final result obtained the funds by borrowing from a third party, a related party, or even an entity wholly owned by the shareholder, is irrelevant. The question is not the source of funds, but whether the S corporation has a *bona fide* debt to the shareholder. In order to clarify this point, the Final Regs. contain two examples.

The first example on back-to-back loans is Example 2 of the Final Regs. This is an extreme version of the classic back-to-back loan transaction whereby the sole shareholder of S corporation 1 borrows funds from S corporation 1 and then loans such funds to S corporation 2 of which the shareholder is also the sole shareholder. Under prior case law, many courts would not honor such a back-to-back loan, as the shareholder is not “poorer in a material sense.” The Final Regs. provide that so long as under the facts and circumstances the loan from the shareholder to the borrowing S corporation is a *bona fide* indebtedness, the shareholder’s basis of indebtedness will support losses from the S corporation.

Example 3 of the Final Regs. is the second example concerning back-to-back loans and involves restructuring a loan between to wholly owned S corporations into a loan between one S corporation and the sole shareholder. Under the facts of this example, the note held by S corporation 1 evidencing the loan to S corporation 2 was distributed to the sole shareholder. In the example, under state law, S corporation 2 would no longer be entitled to payment but only the shareholder would be entitled to payment. This was found to provide basis to the shareholder so long as the debt was a *bona fide* debt of the corporation to the shareholder. The example states that under local law, the debtor S corporation was relieved of its liability to the original lender corporation and was directly liable to the shareholder. Under prior case law, such a loan would not be honored to give the shareholder basis in the debt of the debtor S corporation because the shareholder as the owner of both corporations was not poorer in a material sense. If under local law the debtor S corporation continued to owe either the shareholder or S corporation 1, the tax result is unclear. This situation was apparently raised with the IRS but was not clarified in the Final Regs.

Comments by the ABA Section of Taxation with respect to the proposed regulations requested that, due to the confusion.
on the part of the courts with respect to “the economic outlay standard,” the text of the regulations should clearly state that doctrine does not apply to back-to-back shareholder loans so long as the debt to the shareholder is a *bona fide* obligation. The Final Regs. did not incorporate this comment but the preamble states: “... the Treasury Department and the IRS believe that the proposed regulations clearly articulate the standard for determining the basis of indebtedness of an S corporation to its shareholder, and future discussion of the actual economic outlay test in the regulations is unnecessary. Accordingly, the Final Regs. adopt the rule in the proposed regulations without change.”

The ABA Section of Taxation comments on the proposed regulations also proposed an example of a circular flow of funds to accomplish loan restructurings to wind up with a shareholder loan to the S corporation. The IRS declined to include this or any other example involving circular flow of funds. The preamble of the Final Regs. state: “The Treasury Department and the IRS are aware, however, of cases involving circular flow of funds that do not result in *bona fide* indebtedness. See for example, *Oren v. Commissioner ... Kerzner v. Commissioner ...* whether a restructuring represents in *bona fide* indebtedness depends on the facts and circumstances.”

The failure to have an example in the Final Regs. of a circular flow of funds and the citation to these particular cases greatly concern the author and raise the concern that a sibling concept to “economic outlay,” that of “at risk,” is lurking and may continue to apply. If this is the case, restructuring existing situations to comply with the Final Regs. may be more difficult than a reading of the Final Regs. might indicate.

In *Oren*, the taxpayer owned two S corporations and with his family owned a third. The S corporations were involved in the trucking industry. Dart (the family-owned company) was a motor carrier that provided “truckload” service through the lower 48 states using independent drivers who leased or owned their tractors. HL leased trailers to Dart. HS “leased to purchase” tractors to independent contractor drivers. Due to depreciation on equipment, HS and HL generated tax losses for which Oren needed basis for the losses to pass-through. Over three years, Dart loaned Oren approximately $15 million who in turn loaned the same amount to HS and HL, both of which then contemporaneously loaned the amounts back to Dart. Actual funds changed hands, contemporaneous notes (payment on demand plus 375 days) were executed, interest was paid, and the loans were recorded on the books of the various corporations. The IRS disallowed the increase in basis under Code Sec. 1366(d) because Oren had not made the “actual economic outlay.” As an alternative, if the loans properly increased Oren’s basis, the IRS disallowed the deductions because the funds were not “at risk” within the meaning of Code Sec. 465. The Eighth Circuit stated: “We agree with the tax court that Oren’s loans to HL and HS had no economic substance and, thus, were not real economic outlays.” It is clear the Court of Appeals was applying the “economic outlay standard” with its requirement that the shareholder be made “poorer in a material sense” in order to increase his basis. The Court of Appeals concluded: “Oren’s loans were not actual economic outlays. He was in the same position after the transactions as before; he was not materially poorer afterwards. The transactions much more closely resemble offsetting book entries or loan guarantees than substantive investments in HL and HS.”

In *Kerzner*, Mr. and Mrs. Kerzner had a partnership, which made cash loans to the Kerzners who deposited such amounts in their personal bank accounts. The Kerzners then contemporaneously loaned such funds to their wholly owned S corporation. The S corporation paid equivalent amounts of rent back to the partnership. Judge Nims framed the case: “The issue for decision is whether petitioners made an economic outlay on yearly loans to their S corporation, giving them a sufficient basis in indebtedness under section 1366(d)(1) to claim the S corporation’s losses ...”

The partnership reported the interest income from the Kerzners on the Kerzners’ K-1s and they reported such income on their returns. The Kerzners reported the interest expense as investment interest on their tax returns. The S corporation, however, apparently did not report interest expense nor did the Kerzners report interest income with respect to the loans to the S corporation. This scenario apparently occurred each year from 1986 through 2001. The case involved the 2001 tax year and a loss carryback to 1996 and 1997. The Tax Court found there was no question that an indebtedness ran directly from the S corporation to the shareholders. In the Tax Court’s mind “The issue is thus whether petitioners made an economic outlay on the yearly loans to HCI [the S corporation].” The Tax Court cited *Oren* for the proposition that a brief circular flow of funds designed solely to generate bases in an S corporation has no economic substance. Disturbingly the Tax Court stated: “In the case before us, there is no back-to-back loan situation. Instead, there is a circular flow of funds.”

The refusal of the Treasury and the IRS to include a circular flow of funds example and the citation to these cases
should give taxpayers and their counsel pause in utilizing a circular flow of funds arrangement, either in a restructure or in an initial application. The preamble indicates that there are appropriate circumstances when it will be honored, but only cites cases where the court determined it was not appropriate. However, as discussed above, the basis in these cases for the inappropriateness was the "economic outlay" doctrine, which the regulations are supposed to be rejecting. With respect to a circular flow of funds the regulations may not have eliminated the rationale of economic outlay if the preamble comment is read literally.

Based on presentations by AICPA members on the subject of basis in S corporation stock and debt at the IRS Nationwide Tax Forums during the summer of 2012, the AICPA comments to the proposed regulations recommended an example of a bona fide debt of the corporation to the shareholder which has no adjusted basis and therefore do not support losses. The example used was accrued payroll and bonus payments to the S corporation shareholder by a cash method S corporation. The shareholder would not yet have recognized income and therefore the basis would be zero. The IRS declined to elaborate on this suggestion or provide the example in the Final Regs. believing that the cross-reference to Reg. §1.1011-1 and Code Sec. 1367(b)(2) is sufficient.

Suspended Loss Carry-Forward

The Final Regs. were not amended to alter the historic rules concerning the carry-forward of the amount of losses and deductions for a tax year that are suspended as a result of insufficient basis in stock and debt and the character of such losses and deductions is retained and treated as incurred in the next subsequent year until used by the taxpayer S corporation shareholder.

Contribution of Shareholder Note

The Final Regs. were not amended to modify or clarify how to treat the contribution of a shareholder note to the S corporation that can be enforced by the S corporation. The Final Regs. strictly dealt with basis in the context of debt and the preamble said the Treasury Department and IRS were continuing to study issues relating to stock basis and may address these issues in future guidance. Therefore, the Final Regs. leave unchanged the holding of Rev. Rul. 81-187 that a shareholder does not increase his basis in S corporation stock for purposes of Code Sec. 1366(d)(1)(A) by contributing the shareholder’s own unsecured demand promissory note to the corporation. Such a note has no adjusted basis.

Regulations Are Prospective but Taxpayers May Elect to Apply to the Past

Under Code Sec. 7805(b) the Treasury cannot apply regulations retroactively to any statutory provision enacted after July 30, 1996. However, under Code Sec. 7805(b)(7), the Treasury is permitted to allow taxpayers retrospective application of a final regulation through election. The amended provisions of the Final Regs. are effective for indebtedness between an S corporation and its shareholders resulting from any transaction occurring on or after July 23, 2014. However, S corporations and their shareholders may rely on the Reg. §1.1366-2 with respect to S corporation indebtedness to a shareholder that resulted from any transaction that occurred in a year for which the period of limitations for assessment of tax has not expired before July 23, 2014.

The new Final Regs. are beneficial in establishing that the “economic outlay” doctrine should not apply to determine if a shareholder loan to an S corporation creates basis in indebtedness to meet the requirements of Code Sec. 1366(d)(1)(B).

Conclusion

The new Final Regs. are beneficial in establishing that the “economic outlay” doctrine should not apply to determine if a shareholder loan to an S corporation creates basis in indebtedness to meet the requirements of Code Sec. 1366(d)(1)(B). What constitutes a bona fide creditor-debtor relationship between a shareholder and a borrowing S corporation is determined by general tax principles and taxpayers and practitioners are cautioned that such a determination is based on all the facts and circumstances. The failure to clarify (either taxpayer favorable or unfavorable) the circular flow of funds scenario will result in more litigation and probably more misapplication of the law by the courts and represents a missed opportunity by the IRS to avoid many future disputes.
See Code Sec. 1361 et seq. However see Code Sec. 1374 for the built-in gain tax provision.

2 Code Sec. 1367(a) and (b).

3 Code Sec. 1367(b).


5 Code Sec. 1374 for the built-in gain tax provision.

6 Code Sec. 1367(a) and (b).

7 Code Sec. 1367(b).

8 Code Sec. 1367(b).

9 Code Sec. 752.


16 136 Tax Notes 1558 (Sept. 24, 2012).


19 Id.

20 Bona fide indebtedness is not defined in the regulations. The preamble of the Proposed Reg. §134042-07 states that general federal tax principles—many of which have developed outside of Code Sec. 1366—determine whether indebtedness is bona fide. See K.F. Knettsch, SCt, 60-2 USTC ¶9785, 364 US 361, 81 SCt 132 (disallowing interest deductions for lack of actual indebtedness); J.B. Geftan, CA-3, 98-2 USTC ¶50,630, 154 F3d 61 (based on the objective attributes and the economic realities of the transaction, holding that the transaction at issue was not a bona fide debt); T. Mixon, Est., CA-FC, 72-2 USTC ¶9537 (discussion of factors indicative that debt is bona fide); Litton Business Systems, Inc., 61 TC 367, Dec. 32,263 (1973).

21 Caroline Hay, branch 3 attorney-advisor, IRS Office of Chief Counsel (Passthroughs and Special Industries) and the principal author of the ‘Final Regs.’ responding to a question concerning bona fide debts and whether a written note was required stated that “a written instrument isn’t the be-all and end-all, but that is one of the factors.” 136 Tax Notes 1558 (Sept. 24, 2012).

22 Id. at 1.

23 Id. at 5.

24 See R. Broz, supra note 23.

25 See Oren, supra note 23.

26 T.D. 9682, July 23, 2014. Due to the confusion of revenue agents and the courts in the past, the author anticipates that counsel will need to refer to the preamble from time to time in the future.

27 The court also engaged in an “at risk” analysis and determined that Oren was not “at risk” under Code Sec. 465.

28 See Oren, supra note 23.

29 See Kerzner, supra note 23.